Debt deconstructed
The evolution in debt financing in the UK construction sector
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Research methodology
EY analysed the accounts of the top 10 UK construction companies by revenue (excluding housebuilders) for financial years 2009 - 15.
Introduction

Since 2009, the era of ultra-low interest rates has presented both opportunities and challenges to the UK construction sector. Operationally, margins have come under sustained pressure and for some, the challenge has been to protect – rather than grow – the pipeline. From a debt financing perspective however, many have seized the opportunity to issue new debt at or close to historically low interest rates. Of particular note has been the shift to non-bank financing markets, which provided more than three quarters of the net increase in debt commitments provided to the top 10 UK contractors since 2009. Burgeoning liquidity pools in European and US capital markets since the financial crisis have resulted in ever more competition between individual debt markets, to the particular benefit of borrowers in the sector. With competition has come tighter pricing, more relaxed covenants, greater flexibility on tenor and, in many cases, more favourable operating provisions. This in turn has helped the sector battle against challenging market conditions, in some cases providing the capital financing necessary to support M&A. Access to liquidity has, however, fuelled a net increase in debt levels across the sector, manifested through a significant increase in total credit facilities. In 2015, total disclosed facilities reached 10.5 times the level of combined Earnings before interest, tax, depreciation and amortisation (EBITDA) for the top 10 contractors, up from 6.9 times in 2009. The capital funding and debt refinancing agenda has become an increasingly dominant credit feature of the sector in the post-financial crisis era. Whilst the considerable increase in liquidity across Western debt markets has come to symbolise the post-financial crisis era, so too has that period been impacted by an increase in market volatility. Issuance windows in the capital markets have been less predictable, often impacted by Sovereign and macro-economic events. This has resulted in many market participants running multi-track financing processes; thereby ensuring access to debt funding hasn’t relied on any one market in isolation. We expect this trend to continue and the importance of having maximum visibility across debt markets, including independent advice on financing options and execution strategies, has never been more apparent.
1. Increase in committed debt
Since the start of 2009, when UK interest rates fell to record lows, there has been a significant increase in committed debt facilities to the top 10 UK construction companies (up more than 58% as at FYE’15, with a peak increase of more than 65% in FYE’14).

2. Doubling of drawn debt
Combined drawn debt across the top 10 has more than doubled to £3.1 billion (up 122% since 2009).

3. Reduction in committed facility headroom
As a result of (1) and (2), we have seen a marked reduction in the headroom available within committed debt facilities (down from 58% in 2010 to 42% in 2015).

4. Diversification of financing
Notable diversification of financing away from traditional bank markets; of the net c. £2 billion of additional committed debt facilities added since 2009, 77% has come from non-bank sources. The ratio of bank:non-bank funding has fallen from 6:1 to 1.7:1.

5. Committed facilities equate to 6.0 times EBITDA
Total committed debt facilities as a proportion of the combined earnings of the top 10 has increased to 6.0 times EBITDA; up from 3.5 times in 2009.

6. Debt facilities equate to 10.5 times EBITDA
The amount of total disclosed debt facilities provided to the top 10, including additional bonding facilities (where disclosed), now equates to 10.5 times combined EBITDA; up from 6.9 times in 2009.
Committed debt facilities

The significant increase in total committed debt facilities provided to the top 10 since 2009 demonstrates how accessible the debt markets have been since the financial crisis.

The 58% net increase in committed facilities to £5.6 billion contrasts markedly with an underlying fall in combined EBITDA of 10% over the same period. In many respects, this notable increase in total facilities has come as a result of burgeoning pools of liquidity in US and European debt markets since the financial crisis passed. Banks have competed fiercely to protect key relationships whilst non-bank debt markets have become a significant (and attractive) new source of capital for the sector.

The extension of credit to the UK top 10 doesn’t stop at committed facilities alone. Most of the top 10 make use of significant additional bonding facilities that in turn magnify the exposure of lenders to the sector. Such facilities are typically provided on an uncommitted basis, though reporting disclosure across the sector does not provide a clear view in this regard. Indeed, many companies also use portions of committed bank facilities for bonding/guarantee requirements, so the dependence on and requirements for additional dedicated bonding facilities does vary across the sector.
Since 2009, total disclosed bonding facilities increased 17% to £4.2 billion. These facilities being in addition to the £5.6 billion of committed debt facilities highlighted above. As such, gross debt facilities available to the top 10 can be seen as having increased some 37% since 2009 to stand at almost £10 billion (as at the end of 2015).

Such a material increase in gross debt facilities across the UK construction sector puts further pressure on refinancing requirements in the coming years. This increased refinancing requirement comes amidst the backdrop of an uncertain economic outlook and potential interest rate rises in the medium term. Identifying and protecting refinancing options has never been more important to companies operating in this sector.

**Spoil for choice ...**

UK construction companies have certainly found their stride in diversifying their debt funding since the financial crisis. Principal markets accessed include the UK institutional and US private placement market, convertible bond market, asset backed lending and the lesser-known Schûldschein market, as well as increasing use of international bonding/surety markets. With debt diversification across the sector rapidly rising up the financing agenda, market selection has become increasingly important. Selection and timing intended to take advantage of current favourable market conditions also needs to be tempered with an assessment of future debt servicing, covenants and refinancing risks. As ever, there is no one-fits-all solution and the evolution of business models in the sector will certainly require an evolution of financing strategies to match.
Debt utilisation and headroom

In the context of a net £2 billion increase in total committed debt facilities to the UK top 10, the utilisation of facilities has increased commensurately since 2009.

Total drawn debt broke through the £3.0 billion barrier in 2015, up from £1.4 billion in 2009 – an increase of £1.7 billion, or 122%. Similarly, the combined net debt levels of the top 10 have moved in lockstep, up £1.8 billion from a low of £1.1 billion net cash in 2010 to stand at £700 million (net debt) by the end of 2015.

Of some comfort has been the ability of the top 10 to protect combined cash balances of approximately £2.4 billion despite significant headwinds in cash and working capital management. Optimisation programmes have delivered significant benefits to a number of the largest UK contractors and have suppressed what would have otherwise been a more significant rise in net debt across the sector.

The sharp increase in drawn debt across the top 10 has, however, eroded headroom in total committed facilities. The proportion of available committed headroom has fallen from a high of 58% in 2010 to a low of 42% by the end of 2015 – a level that was also hit in H1 2012. If trading conditions remain challenging in the near term, it is entirely possible headroom could fall further toward the emotive one-third level, a point where some may reassess whether a return to the debt markets would be warranted. In the context of total facilities to the top 10 now standing at almost £10 billion, any return visit to the debt markets could prove more challenging – the pressure on cash management and balance sheet strength remains clear to all.
The combined EBITDA of the top 10 increased from over £1.0 billion in 2009 to peak at over £1.2 billion by the end of 2012, but has since fallen to c. £940 million as at the end of 2015.

Comparing this to the increase in both total committed and uncommitted facilities (including bonding facilities where disclosed) highlights how debt facilities as a multiple of EBITDA has increased markedly since the financial crisis.

The ratio of total committed debt facilities to last twelve months (LTM) EBITDA has increased from c. 3.5 times in 2009 to almost 6.0 times as at the end of 2015. This ratio is estimated to have increased further in the first half of 2016 due to additional financing activity seen in the sector.

If including additional uncommitted bonding facilities (where disclosed), the ratio of total debt facilities to EBITDA has increased from 6.9 times in 2009 to almost 10.5 times by the end of 2015.

In reality, this ratio will be higher still due to other ancillary facilities used in the sector (such as supplier financing) that are presented separately to principal debt facilities in company balance sheets. These figures also exclude any bonding/guarantee facilities not disclosed by individual companies - something that is a known feature in this sector - along with any other contingent liabilities that are not recognised as debt in financial reports.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
<th>FY13</th>
<th>FY14</th>
<th>FY15</th>
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| Leverage multiple
| 3.4x | 6.9x | 6.0x | 4.0x | 2.0x | 0x |

### Ratio of committed debt facilities and total debt facilities to LTM EBITDA

![Graph showing the ratio of debt facilities to EBITDA from FY09 to FY15, with a peak at 6.0x in FY10 and 10.5x by the end of FY15.](image)
Whilst the quantum of debt facilities provided to the top 10 is noteworthy, of particular interest is the change in the ratio of gross debt to EBITDA and net debt to EBITDA since the financial crisis. These two ratios are typically viewed as pivotal credit metrics from a lender/investor standpoint, especially when identifying medium-term trends in operating performance. The ability to improve cash conversion and the use of that cash both have a strong bearing on debt capacity, manifested in upward or downward movement in gross and net debt to EBITDA ratios.

Since 2009, the top 10 have seen gross debt to EBITDA increase from 1.3 times to 3.3 times, having peaked at 3.8 times in H1 2015.

Similarly, net debt to EBITDA has also increased from -0.9 times (net cash) in 2009 to 0.8 times as at the end of 2015. The transition from net cash to net debt occurred in the first half of 2013 and since then the top 10 have seen combined net debt to EBITDA fluctuate between 0.5 and 1.0 times. The differential between gross and net debt leverage ratios has typically held in the 2.0-2.5 times range, albeit lows of 1.75 and 1.63 times for H1 2013 and H1 2014 respectively. This was consistent with the timing of additional debt raising exercises where cash headroom was under particular pressure across the sector.
Evolution in credit spreads

The evolution in European investment grade and high yield credit spreads in the sector demonstrates how attractive the primary debt markets have been in recent years.

Benchmark five-year credit spreads saw a substantial jump in the summer of 2011 due to heightened volatility in equity markets - a period that saw the high yield market effectively shut to new issuers for a number of months. Since that time, credit spreads have steadily contracted, reaching lows in Q2 2015 in the area of 0.55-0.6% for investment grade issuers and 2.2-2.3% for high yield issuers. Subsequent macro-economic concerns both in Europe and in Global debt markets saw credit spreads widen by a factor of approximately 2.5 times through to the end of January 2016. Since then, improved sentiment has allowed a contraction in credit spreads back to around 110 basis points (1.1%) for investment grade issuers and around 350 basis points (3.5%) for high yield issuers. Current market conditions remain attractive for new issuers and we expect increased activity in the debt markets in the second half of 2016 as a result.

Alternative markets have come to the forefront, with private debt funds and specialist loan markets seeing a marked increase in activity as those with financing requirements have increasingly found a safe haven away from traditional public / institutional markets. Competition between private and public debt markets is likely to remain a feature for borrowers of all sizes in the near term and, subject to changes in the underlying interest rate environment, possibly for the longer term as well.
Evolution in cost of debt: UK benchmark five-year yields

Whilst prevailing credit spreads for investment grade and high yield borrowers will always be a closely watched metric, of more significance to borrowers is the shift in the overall cost of debt financing since the financial crisis.

By factoring in benchmark yields, an analysis of all-in cost of debt (excluding one-off issuance costs) demonstrates how rates have fallen consistently since the start of 2016 to levels close to historic lows.

Having peaked at almost 3.75% in mid-2011, five-year benchmark investment grade coupons now stand at around 1.75%, having dipped as low as 1.4% in Q2 2015. The last six months alone has seen a contraction of around 1.0%, of which about half relates to falls in underlying benchmark (Gilt) rates. The fall in credit spreads is symptomatic of a lack of M&A deal flow in the first half of 2016, which in turn has created an oversupply of liquidity in the capital markets that we anticipate will remain a feature during the second half of 2016.

High yield coupons have experienced more significant volatility since the financial crisis, with a dramatic peak reached in the summer of 2011 as equity markets came under significant strain. Since the start of the year, five-year high yield coupons have fallen by around 1.25% to now stand at just under 4.2%, though this is about 1.0% higher than historic lows seen in Q2 2015. Volatility in high yield credit indices has impacted debt issuance windows in the capital markets, with a number of companies having to postpone, restructure or even abandon debt issuance in the public market in the last 12 months. European high yield primary flow gathered pace in Q2 2016, though market volatility continued to hamper issuance planning. Companies have had to prepare transactions well in advance to permit quick access to markets when conditions have been deemed attractive enough.

In both the investment grade and high yield markets, the minimum return requirements of debt providers remains arguably the most important factor in determining when and at what level the floor in debt funding costs will be reached. For many on the buy-side, the floor has already been reached, courtesy of the significant oversupply of liquidity in the current market. This has created conditions in which lending to higher quality investment grade companies has become uneconomic for banks on a standalone basis. Whether the up-turn in debt funding costs will come as a result of increased demand for credit (e.g. in support of M&A activity), increases in benchmark interest rates, or a reduction in liquidity due to macro-economic factors remains open to debate. In reality, it is likely to be a combination of all three factors and, if history is any guide, the transition in financing costs will likely occur in a volatile manner. Optionality in the context of debt funding remains the byword for many companies in the post-financial crisis era.
Conclusion

The debt markets have been particularly supportive of the UK construction sector since the financial crisis, as evidenced by the net £2.0 billion of additional committed lending provided to the top 10 since 2009.

This in turn has allowed those companies to weather the storm of increased competition, reduced operating margins and a decline in major infrastructure spend.

The steady fall in benchmark rates since the financial crisis has allowed many construction firms to secure debt financing at or close to record lows (on an all-in cost basis), in turn helping reduce their weighted average cost of capital. This has, to a degree, cushioned the impact of challenging market conditions on equity returns, though sustained economic pressures continue to adversely impact financial results. The full impact of the result of the UK’s referendum on EU membership is particularly uncertain, albeit the immediate aftermath saw further falls in benchmark rates with associated increases in credit spreads.

Ready access to debt markets on favourable terms has been a boon for the sector in recent years, though much of the sector’s latent debt capacity has now been tapped. We therefore anticipate a transition to headroom management and subsequent deleveraging in the medium term, subject to prevailing economic conditions. Whether this deleveraging comes from stronger earnings growth or net reductions in debt levels in real terms remains to be seen. In reality, it is likely to be a combination of both of those factors, though in the absence of earnings improvement the pressure on deleveraging will only increase.

How this influences the refinancing agenda will be critical, with many in the sector now facing a period of margin protection, performance improvement, business rationalisation and - subject to market conditions - consolidation. Planning for the next wave of refinancings at an early stage and facilitating optionality across multiple markets will be crucial to limiting transaction execution and balance sheet risks. Refinement of credit positioning, engagement with existing lenders and pre-positioning transactions can all make a significant impact on the likelihood of success. The EU referendum outcome only magnifies these requirements, as lenders become increasingly selective on those companies they are prepared to support in the future.

Market conditions and macro-economic factors will undoubtedly remain the key determinant of future financing strategies – for some this could require a change of tack at relatively short notice. Ongoing UK-EU political negotiations only adds an extra layer of complexity to financing strategy, albeit one for which borrowers have no control over. For most if not all companies in the sector, there is typically only one way of approaching the financing conundrum; explore your financing options thoroughly and plan for all credible scenarios.
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